PRIVATE EQUITY FUND-OF-FUNDS: Diversification, Returns, and Access
The private equity industry has grown to become a highly successful, global investment model for putting long-term investor capital to work to transform companies and generate attractive returns. Fund-of-Funds (FoFs) have played an integral role in the industry’s evolution by providing investors with a competitive and cost-effective vehicle to achieve:

> Diversification benefits
> Attractive returns
> Access to the best managers
> Exposure to fund strategies customized to meet specific needs

Today FoFs are at the center of the global private equity ecosystem and have earned their reputation as the “reference investor” for limited partners and the “preferred investor” for fund managers.

Like the success of the broader private equity industry, FoFs’ track record at selecting, investing with, and monitoring the growing number and types of fund managers is tied to the alignment of investor and general partner interests achieved through the limited partnership structure. With over 40 years of experience and with $1.4 trillion in assets under management, this is indeed a proven model.
Introduction
A Proven Private Investment Model

Over the past four decades there has been dramatic growth in the amount of private equity capital raised and deployed, which has reflected the success of the asset class as a long-term investing model. At $1.4 trillion, buyout funds represent the largest portion of the industry’s $3.8 trillion in assets under management (see Chart 1). Private equity’s success at generating returns that outperform public markets can be traced to the alignment of limited partner (LP), general partner (GP), and portfolio company management interests created by the limited partnership fund structure. This requires, among other conditions, GPs to share in the profits/losses on investment, commit substantial personal capital to the fund, and submit to regular scrutiny of their track records, investment strategies, and teams to raise sequential funds.

![Chart 1: Total Number of PE Firms and AUM](image)

Source: Prequin, 2015.

“Primary” private equity funds raise capital from investors, invest in companies, and then look to exit over the 10-year life of a fund. In comparison, Fund-of-Funds (FoFs) invest across a number of primary funds to gain both attractive returns and an additional level of diversification (see Chart 2). FoFs emerged early in the industry’s history as a cost-effective vehicle for investors to access the best private equity managers that make direct investments through primary funds. FoFs can play an instrumental role providing specialized investment skills for those looking for lower-risk exposure to the asset class. Because private market investments are much more opaque and complex than public market investments (as privately-held portfolio companies do not file publicly-available financial statements), smaller and newer investors often find themselves at an information disadvantage. FoFs can play an instrumental role providing specialized investment skills for those looking for lower-risk exposure to the asset class.
FoFs have grown and evolved alongside the broader private equity industry into a global business with multiple strategies. Intense competition and specialization have driven this subset of the industry to become one of the most dynamic – launching new offerings and solutions driven by the needs of new and existing investors. The last decade has witnessed traditional FoFs maturing into global platforms that can provide investors with integrated services including co-investments, secondary investments, and separately managed accounts (SMAs).

**CHART 2  THE STRUCTURE OF A FUND-OF-FUNDS**

The staying power of FoFs is tied to their integral role in the dynamic and global private equity industry. Like private equity in general, investors value FoFs for their ability to provide diversification and attractive return profile benefits. In addition, FoFs can provide investors with access to the best managers and increasingly with fund strategies to meet specific needs. Ultimately, the true value proposition of FoFs lies in their ability to cost-effectively access the long-term outperformance of private equity, and to do so with relatively lower risk.
Private Equity Mechanics and Growing Application

The growth of the private equity industry has attracted increased media and regulatory attention. It has also become the focus of a growing number of consultants and academics focused on the industry’s performance. Research demonstrates that over the long term, private equity has outperformed public market indices (after fees and expenses). According to consultant Cambridge Associates’ quarterly performance data, private equity outperforms public equity over the long term, even when the public indices are leveraged to mimic private equity (see Chart 3).

These results also hold using the latest benchmarking metric, the public market equivalent (PME), which provides a more like-for-like comparison by mimicking the timing of cash flows in private equity funds. As Bloomberg recently noted “Increasingly, limited partners are using public-market equivalent benchmarks to evaluate past investments and make decisions...PMEs are more complex to calculate but are on better methodical footing.”

CHART 3  GLOBAL PRIVATE EQUITY / VENTURE CAPITAL PERFORMANCE (As of December 31, 2014)


ROBUST INVESTMENT MODEL BASED ON ALIGNMENT OF INTERESTS

As a result of this robust investment model and persistent outperformance, private equity has expanded across investment stage and size (from startups to billion-dollar Fortune 500 companies), industries, and geographies. Ultimately, the 10-year, closed-end limited partnership fund structure, which aligns GP and LP interests, has made this model successful and adaptable. Terms including GP commitments, profit sharing (“carried interest”), management fees, and hurdle rates provide powerful incentives for GPs to be highly focused and engaged throughout the process of identifying and evaluating investments, executing value creation strategies, and exiting the investment. The model also provides investee companies the “patient capital” to execute their business plans. Additionally, by requiring portfolio management teams to become meaningful investors in their companies, GPs align company management’s interests with their own and those of their investors – driving performance and accountability.
THE BENEFITS OF DIVERSIFICATION

In addition to attractive risk-adjusted returns, investors are also attracted to private equity for its diversification benefits. As long-term investments in private companies, private equity is typically not correlated to other asset classes. The illiquidity of the investments and the fact that they are typically valued on a quarterly, not real-time, basis means private equity is less sensitive to public market movements, and can therefore reduce volatility in an investor's broader portfolio. In addition, diversification is gained by investing across companies in different industries, company life-cycle stages (venture, growth, buyout), and geographies.

Finally, the industry mix of a typical private equity portfolio tends to be very different than that of a public market index. For example, while more capital-intensive companies such as those in the oil & gas, banking, and insurance sectors are often major components of most public indices, they are typically a smaller portion of private equity funds. In addition, the sheer number of private companies compared to public companies indicates the advantage of building diversified private equity FoFs. For example, of the more than 20 million small and medium-sized enterprises in Europe, only about 20,000 are publicly traded.9

GROWTH IN INVESTORS

Private equity’s success has driven dramatic growth across the asset class’ global ecosystem over the last 20 years, with increased competition fueling industry specialization and distinctive strategies. This success has also attracted a growing number of investors – often with different levels of expertise and resources.

Private equity’s return profile and 10-year limited life fund structure are particularly attractive to institutional investors such as pension funds and endowments, which have long investment horizons and known funding requirements. Consequently, these investors have steadily increased their exposure with some of the more experienced investors, such as the Canada Pension Plan Investment Board (17.7% of its assets in private equity)6 and Washington State Investment Board (24% allocation to the asset class)7 moving their private equity allocations within their overall portfolios from single to double digits. Other investors include wealthy individuals and family offices, with the latter having the greatest allocation to the asset class (see Chart 4). Sovereign Wealth Funds (SWFs) are increasingly active investors in private equity and may over time become one of the industry’s largest investors given their size and long-term investment horizons.

---

CHART 4 AVERAGE CURRENT ALLOCATION TO PRIVATE EQUITY BY INVESTOR TYPE (AS A PORTION OF AUM)


---

Private equity’s return profile and 10-year limited life fund structure are particularly attractive to institutional investors such as pension funds and endowments, which have long investment horizons and known funding requirements.
A BROADERING MENU OF PRIVATE EQUITY OFFERINGS

The success and adaptability of the private equity model have enabled the traditional co-mingled fund structure to be replicated to other alternative classes such as real estate, infrastructure, and private debt funds. Competition and specialization have also led private equity managers to focus increasingly on specific industries, geographies, and company sizes. Similarly, FoFs have continued to evolve and offer investors new products (primary funds, co-investments, secondary investments, and customized solutions through SMAs) to meet investors particular investment objectives while at the same time mitigating risk and achieving attractive returns.

Fund-of-Funds Performance

What Does the Evidence Say?

Alongside private equity in general, there is a growing body of empirical and theoretical research that provides insight into how FoFs work and whether they can provide value to investors. A comprehensive recent paper evaluating FoF performance was produced by a team of business school professors with extensive private equity research track records. In this paper, the researchers benchmarked FoF performance (net of all management and performance fees) against public equity markets and direct private equity investments over the years 1987 to 2007. As indicated in Chart 5, the researchers found that FoFs provide average and median S&P 500 PMEs greater than one, indicating that FoF returns outperform public equities and proving that private equity generates real alpha above market returns.

<table>
<thead>
<tr>
<th>Vintage Year</th>
<th>Number of FoFs</th>
<th>Average</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987-2007</td>
<td>294</td>
<td>1.13</td>
<td>1.08</td>
</tr>
<tr>
<td>1997-2007</td>
<td>280</td>
<td>1.11</td>
<td>1.08</td>
</tr>
<tr>
<td>VY Aug 97-07</td>
<td></td>
<td>1.16</td>
<td>1.15</td>
</tr>
</tbody>
</table>

Source: Harris, Jenkinson, Kaplan, and Stucke (August 2015)

In a paper published in the Journal of Investment Management, a different team of researchers analyzed the tradeoffs faced by investors choosing between investing directly into a fund or with a FoF. Looking at hedge funds, the research indicates that the returns of FoFs should not be evaluated with those of a direct fund, but instead with the actual returns an individual investor could capture given its capital, risk tolerances, and costs. The study concludes that on average, FoFs can add value for investors by highlighting the meaningful costs and skill levels involved in identifying, evaluating, and monitoring good managers – as well as being able to assess them – and the fact that these are not evenly distributed across investors.

Finally, in a recent paper published by the Coller Institute of Private Equity, the authors completed a comprehensive assessment of the evolution of the private equity business model and found that FoFs have been one of the most dynamic parts of the business. Responding to competition, FoFs have moved to offer co-investment and secondary opportunities as well as SMAs. The study cites Preqin to note that FoFs use separate accounts twice as often as traditional direct funds. The authors find that FoFs continue to stand out for their ability to evaluate managers and build diversified portfolios that can reduce return variance. Investment consultants, an increasingly direct competitor with FoFs as they move into asset management, face potential conflicts of interest given their traditional service of providing independent advice.

The authors find that FoFs continue to stand out for their ability to evaluate managers and build diversified portfolios that can reduce return variance.
Fund-of-Funds
Performance Drivers

Viewed over time, the performance and growth of private equity FoFs (like the broader industry) have continued to both evolve – providing new services to meet investor demands – and generate core investor benefits such as diversification and access. The co-mingled fund structure and limited partnership model, which aligns investor and fund manager interests, has provided a strong foundation for enduring performance and expanded offerings.

Five distinct components of the private equity FoF investment process, when efficiently integrated, have the potential to generate highly attractive performance benefits for investors.

PERFORMANCE DRIVERS
1. Manager Selection
2. Portfolio Construction and Diversification
3. Fund Monitoring
4. Access to GPs and Investments
5. Organizational Scale and Cost

MANAGER SELECTION

Identifying managers capable of creating value across investment cycles is the cornerstone of the FoFs business. This involves a resource, expertise, and organizational-intensive vetting process focused on evaluating a number of fund manager attributes, including an investment team’s cohesiveness and culture and a manager’s investment strategy, investment process, and track record.

Manager selection is especially critical in private equity as it involves committing capital over long periods. As indicated in Chart 6, the dispersion of returns between top and lower quartiles is greater in private equity than other asset classes, indicating the significance of a manager’s specific skills and experience in creating value. In addition, as competition has increased, the persistence of GP performance has weakened and investors are therefore less able to rely on past performance as a key indicator when selecting a fund. Consequently, the complexity of identifying top-performing managers has increased.

CHART 6 10-YEAR DISPERSION OF ASSET CLASS RETURNS

Source: J.P. Morgan Asset Management, 2016 Long-Term Capital Market Assumptions, 2015, p. 35. Original data sourced from Thomson Reuters Lipper; Burgiss, J.P. Morgan. Equity is defined as all U.S. large cap, U.S. mid cap, and European mutual funds with at least 10 years of performance. Fixed income is defined as all U.S. core fixed income managers with at least 10 years of performance. Private equity is defined as all private equity returns over the last 10 years, represented by the asset-weighted Burgiss Corporate Finance Fund Composite. All data shown through December 31, 2014. Return figures are derived from an equal weighted average of quartiles and therefore may exhibit size bias.
PORTFOLIO CONSTRUCTION AND DIVERSIFICATION

Achieving superior risk-adjusted returns and diversification benefits requires building a portfolio of investments with an array of fund managers. Where direct funds achieve diversification by investing in different companies, FoFs achieve a second level of by investing across multiple fund managers. Diversification is broadened by investing in different strategies, investment stages, and geographies – which together help to further mitigate risk. A recent BVCA study which evaluated risk in private equity investment concluded that “an investor has a very low probability of losing any capital over the lifetime of the funds when investing in a diversified private equity portfolio with a number of funds.”

FUND MONITORING

The FoFs investment process is highly disciplined and engaged, requiring intense monitoring of an investment team’s performance and strategy, as well as the market environment, which can generate risks and opportunities. FoFs that are expert and experienced investors often participate on private equity fund advisory committees where they can gain access to better information and position themselves to provide insights on the global market, strategic evaluation, and relationships.

As a result of their experience and expertise, leading FoFs are increasingly considered “reference” investors, and their investments with fund managers can act as an important signal to manager quality. These attributes also make FoFs valuable to GPs, and successful FoF managers can become “preferred” investors given the highly professional, value-add services they bring to investing.

ACCESS TO GPS AND INVESTMENTS

Private markets are by nature less open, transparent, and efficient than public markets – and therefore less accessible. Information about market opportunities is not as readily available as the real-time information around public markets. Also, investing in private equity is restricted to sophisticated investors who often face higher minimum threshold constraints and access issues in addition to significant manager selection challenges. Constrained access is especially the case with respect to leading venture capital and buyout funds, which often become over-subscribed early in the fundraising process.

Experienced FoFs, particularly those with extensive GP relationships and global platforms offering a wide array of fund alternatives, can help investors bridge the access and information gap by quickly and efficiently providing exposure to specific strategies, regions, industries, and investment stages. In addition, FoFs give small investors the opportunity to scale up and invest in larger companies. Accessing these through a direct fund could be impractical given minimum investment size limitations or imprudent given the loss of diversification benefits. Conversely, investing with a FoF gives larger investors the opportunity to scale down and gain exposure to smaller companies that would otherwise involve higher transaction costs through direct investing.

Finally, growing regulatory and legal barriers are putting a premium on the role of FoFs to offer investors fund manager choices that they would otherwise not be able to evaluate or access. This has proven true particularly with the enactment of the Alternative Investment Fund Manager Directive (AIFMD), which was intended to harmonize the European Union (EU) regulatory framework for alternative investment funds, but has materially raised the cost for non-EU market funds to raise capital in the region. The added burden of significant registration and compliance requirements is forcing some non-EU managers to bypass the continent in their marketing efforts. Similarly, this burden is preventing some European investors from gaining the diversification benefits of accessing the global pool of private equity managers and the potential to increase returns.
ORGANIZATIONAL SCALE AND COSTS

Ultimately, it is critical for private equity managers to provide cost-effective professional fund manager identification, evaluation, investment, and monitoring services. To the great benefit of FoFs’ investors, this business, like the broader private equity industry, is highly competitive. It is experiencing consolidation as less efficient players exit and new service providers enter. This trend has encouraged innovation (e.g., new product offerings such as SMAs), stimulated integration (combining primary fund, co-investment, and secondary investment opportunities to provide a broader range of cash flow profiles), controlled costs, and reduced management fees.\(^{17}\)

Global private equity investing is complex: it involves a broad range of investment strategies, GP performance is no longer persistent, and the business environment is highly regulated. Consequently, successful FoFs have had to invest substantial resources into their operational, governance, compliance, regulatory, and legal teams to respond to these changes. Importantly, integrated strategy offerings have provided synergies in terms of team coordination, deal sourcing, relationship sharing, and value creation.

Recently, several large institutional investors have moved from (a) FoFs investing to (b) directly investing in primary funds to (c) investing directly into portfolio companies. There are real limits to investors’ ability to replicate this evolutionary private equity investing model. One of the important limitations is scale – the ability to build a global investment platform with the necessary investment and operational resources and governance discipline to execute across all stages of the investment process. In its most recent global private equity report, Bain & Co. reported that the number of investors of sufficient size to access the market on their own is only about 100, or less than 2% of the overall LP base.\(^{18}\)

In addition to acquiring the necessary resources, as indicated by the Coller study, additional limitations to direct private equity investing include governance and compensation (see Chart 7). The hallmark feature of private equity is its co-mingled partnership fund model that aligns LP and GP interests by structuring funds with a GP commitment, carried interest, preferred returns, and the necessity of getting vetted by the market in order to raise future funds. All of these factors contribute to the unique success of the FoF model and point to meaningful barriers to its replication by individual institutional investors.

**CHART 7  SUMMARY OF FACTORS THAT LIMIT THE ABILITY OF LPs TO INVEST DIRECTLY**

<table>
<thead>
<tr>
<th>Governance Structure</th>
<th>Many LPs have governance structures that entail political interference in investment decisions and slow decision making processes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation Structure</td>
<td>Legal constraints and political pressure prevent most LPs from being able to attract and retain the best private investors</td>
</tr>
<tr>
<td>Headline Risk</td>
<td>A single poorly performing deal can result in backlash from the public that forces an LP to scale back its entire PE program</td>
</tr>
<tr>
<td>Cost Structure</td>
<td>Only LPs with very large PE portfolios will be able to spread high fixed costs over enough deals to potentially reduce costs relative to PE firms</td>
</tr>
</tbody>
</table>

Source: Jacobides and Saavedra, Coller Institute of Private Equity, October 2015.
Conclusion
Reference Investor for LPs; Preferred Investor for GPs

The private equity industry is a highly dynamic business, managing institutional investors’ capital over the long term and persistently generating excess investment returns across industries, investment stages, and geographies while limiting downside risk. Operating under the same co-mingled private partnership structure that aligns LP and GP interests, FoFs have played an integral role in providing investors with a competitive and cost-effective investment process to provide:

> Diversification benefits
> Attractive returns
> Access to the best managers
> Exposure to fund strategies to better meet specific objectives

Similar to the broader private equity market, FoFs continue to evolve and perform — providing new strategies to meet investors’ needs and a low-risk alternative for generating returns that can outperform public markets. In the growing private equity ecosystem they provide a key monitoring and disciplinary role over GPs as well as a financial intermediary role for investors at a resource or knowledge disadvantage.

Private equity FoFs have earned their reputation in the LP community as the “reference investor” given their experience and expertise, and among GPs as their “preferred investor” given the value-add attributes they bring to investing.

2. The terms “GPs” (general partners) and “fund managers” are used interchangeably.
3. See also Robert S. Harris, Tim Jenkinson, Steve Kaplan, “Private Equity Performance: What Do We Know?”, *Journal of Finance*, Vol. 69, Issue 5, October 2014, which found that private equity outperformance versus S&P 500 averages 20% to 27% over a fund’s life and more than 3% annually.
9. In this instance, greater than one indicates that the ratio of all cash distributions and any residual value of the funds at the public market total return to the value of all cash distributions discounted (or invested) at the public market total return is positive.
15. In a recent HarbourVest Partners FoFs, 90% of the 18 venture capital managers (with multiple funds) were oversubscribed as were 81% of the 24 buyout managers (with multiple funds).
17. Across the industry there have been changes in fee structure that include reduction in the overall management fee and the introduction of volume and loyalty discounts. In the case of HarbourVest clients, some have seen reductions of over 50% in the fee structure.
HarbourVest is an independent, global private markets investment specialist with more than 30 years of experience and $37 billion in assets under management. The Firm’s powerful global platform offers clients investment opportunities through primary fund investments, secondary investments, and direct co-investments in co-mingled funds or separately managed accounts. HarbourVest has more than 300 employees, including 86 investment professionals, across Asia, Europe, and the Americas. This global team has committed more than $30 billion to newly-formed funds, completed over $13 billion in secondary purchases, and invested $5 billion directly in operating companies. Partnering with HarbourVest, clients have access to customized solutions, longstanding relationships, actionable insights, and proven results.